VZCZCXRO5866
PP RUEHCHI RUEHFK RUEHHM RUEHKSO RUEHNAG RUEHPB RUEHRN
DE RUEHWL #0847/01 3410507
ZNR UUUUU ZZH
P 070507Z DEC 07
FM AMEMBASSY WELLINGTON
TO RUEHC/SECSTATE WASHDC PRIORITY 4937
RUEHRC/DEPT OF AGRICULTURE WASHDC PRIORITY
INFO RUEHXQ/ALL EUROPEAN UNION POST PRIORITY
RUEHZU/ASIAN PACIFIC ECONOMIC COOPERATION PRIORITY
RUEHSS/OECD POSTS COLLECTIVE PRIORITY
RUEHBY/AMEMBASSY CANBERRA PRIORITY 5043
RUEHOT/AMEMBASSY OTTAWA PRIORITY 0301
RUEHNZ/AMCONSUL AUCKLAND PRIORITY 1561
RUEHDN/AMCONSUL SYDNEY PRIORITY 0613
RUCPDOC/USDOC WASHDC PRIORITY 0197
RUEAWJA/DEPT OF JUSTICE WASHINGTON DC PRIORITY
RHHMUNA/CDR USPACOM HONOLULU HI PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHRC/USDA FAS WASHDC PRIORITY 0370
RUEHBS/USEU BRUSSELS PRIORITY

UNCLAS SECTION 01 OF 05 WELLINGTON 000847

SIPDIS

SIPDIS

EAP/ANP, EEB/TPP/ABT, STATE PASS TO FAS KHALIKA MEARDY -
OCRA, PAUL KIENDL - OGA, JIM DEVER - OFSO, COMMERCE FOR
ITA/MAC/AP/OSAO, PACOM FOR JO1E/J2/J233/J5/SJFHQSTATE

E.O. 12958: N/A
TAGS: EAGR ECON EFIN ETRD PREL NZ XV
SUBJECT: FONTERRA - NEW ZEALAND'S LARGEST COMPANY PLANS TO
FLOAT FIRST INITIAL PUBLIC OFFERING

WELLINGTON 00000847 001.2 OF 005

¶1. Note: This is a joint Foreign Agricultural Service and
State report. End note.

¶2. Summary. Fonterra Co-operative Ltd, New Zealand's largest company is beginning a two-year consultation with its farmer shareholders whether to approve a preferred capital restructuring option. If approved, Fonterra would transfer its assets, liabilities and operations to a separate company that would be listed on the stock exchange in 2010. Outside investors could purchase up to 20 percent of the shares, which would enable Fonterra to raise capital for planned expansion into overseas markets, primarily China, other countries in Asia, and South America. Fifteen percent of the shares would be provided to existing farmer shareholders and the remaining 65 per cent would be held by the co-op. Fonterra controls nearly 40 percent of global trade in dairy exports, and its 2007 assets of NZ$12.6 billion (US$10.1 billion) and revenue of NZ$13.9 billion (US$11.2 billion) mean it could eclipse the currently largest listed company on the New Zealand Stock Exchange - Telecom. While potential investors have responded positively to the plan, Wall St. expressed cautious optimism but the initial reaction of farmer shareholders has been mixed. End summary.

Who Is Fonterra

¶3. The Fonterra Co-operative Group was formed by the merger of New Zealand Dairy Group, Kiwi Co-operative Dairies, and the New Zealand Dairy Board in late 2001. The group is owned by its 11,000 dairy farmer shareholders and is the world's largest exporter of dairy products, exporting 95 percent of New Zealand's production. Fonterra controls about 40 per cent of world dairy trade and exports to more than 140 countries with 32 per cent going to Asia, 25 per cent to the Americas, and 21 per cent to Oceania. With its 2007 assets amounting to US$10.1 billion and revenue of US$11.2 billion

Fonterra could eclipse the currently largest listed company on the New Zealand Stock Exchange - Telecom. Fonterra is considered a "partnership model" because of the growing number of foreign companies with which it has established partnerships. This strategy enables it to access dairy markets where dairy demand is met by local supply. Partnerships, such as joint ventures, give Fonterra market access without major capital investments and financial risks, while providing mutual benefits to both companies.

¶4. In North America, Fonterra has already teamed with Dairy Farmers of America, the largest farmer-owned dairy cooperative in the U.S. The resulting partnership, DairiConcepts, produces and markets milk protein concentrates. Fonterra has also entered into an agreement with Dairy America, a federated marketing cooperative, to serve as the marketing agent for the nonfat dry milk received from its members (seven U.S. farmer-owned dairy cooperatives). In the U.S. market, Fonterra is a buyer and an exporter of U.S. nonfat dry milk to other foreign markets. Its other partnerships include joint ventures with Nestle through Dairy Partners Americas in South America, Arla Foods in the United Kingdom, Clover Industries in South Africa, and Britannia Industries in India. Fonterra is the world's largest dairy ingredients company, but is also a supplier of consumer branded products, such as its Anchor brand butter, Anlene brand milk powders, and Mainland brand cheese products. Fonterra has a major stake in the Australian dairy company, Bonlac Foods Limited, and has undertaken the formal merger of both companies' consumer products operations in Australia and New Zealand.

Fonterra Announces IPO

¶5. On November 15, 2007, Fonterra, the largest company by

turnover in New Zealand and the world's fifth largest dairy company by revenue, presented for consideration to its members, six options for a fundamental capital restructuring, including the Fonterra Board's preferred option that would result in the co-operative listing its business operations in a separate company, while maintaining a controlling interest. Under the preferred option, initially farmers would own about 80 per cent of the listed entity, 65 per cent through the co-operative and around 15 per cent through their own shareholding in the listed entity. The remaining 20 per cent would be available to the public. Fonterra wants to change its capital structure to address three pressures on its current structure - redemption risk, investment choice for farmers, and the need for a secure and expanding capital base to implement its growth strategy. The preferred (i.e., announced) option was the only one of six the Board considered that would achieve all three goals.

¶6. Two years of consultations and two rounds of shareholder voting will be required in order to implement the initial public offering (IPO). In May of 2008, Fonterra's 11,000 shareholders will vote on whether to allow Fonterra to change to the two-entity structure and to adopt a more transparent milk pricing system. The milk price system will be used to determine the price by which the co-op transfers milk produced by shareholders to the new company. The second vote, which will probably be around May 2010, will determine whether to let Fonterra list on the stock exchange in order to generate external capital. In both ballots, 75% of shareholders must vote to approve the measures.

¶7. Of the six options presented to members by the Fonterra Board, the preferred option was the only one that would achieve all three goals of implementing growth strategy, reduce risk, and create flexible investment choices for farmers. The start of the consultation process comes two months after Fonterra announced a record payout to suppliers of NZ$6.40 (US$5.12) per kilogram of milk solids. "While

NZ$6.40 (US$5.12) is good for farmers, it doesn't give the Co-operative the capital to implement our strategy," said Fonterra's Chairman, van der Heyden. "It may lessen the redemption risk for a while, but that is debatable because our shareholders can choose to redeem their shares regardless of the level of payout. And NZ$6.40 (US$5.12) does nothing to address shareholder investment choice," per van der Heyden.

Pre-Conditions for Fonterra Listing on Stock Market
-- ------

¶8. The following conditions must be met before the IPO can be launched:

- 75 per cent farmer shareholder approval to create parent co-op and operating subsidiary and a transparent milk pricing system (to be voted on by 11,000 Fonterra farmer shareholders in May 2008).
- A competitive milk pricing mechanism.
- Superior business performance across Fonterra.
- Acceptable share market conditions.
- Acceptable listing value for current shareholders.
- Acceptable legislation to support necessary changes.
- 75 per cent farmer shareholder approval in second vote (expected around 2010) of listing and raising external capital.

Floating Fonterra: Process, Structure, Safeguards
-- ----

¶9. The process calls for two years of consultations and two shareholder votes. The first vote is scheduled for May 2008. Fonterra farmer shareholders will vote on: splitting Fonterra into two entities - a parent co-op and a separate company with manufacturing and marketing responsibilities;

and a milk pricing system that determines the price for transferring milk from the co-op. The second and final vote is expected around May 2010. Shareholders will vote on listing on the stock market and raising external capital. In both votes, 75 percent approval of shareholders is required for the measures to pass. The two-year consultation process will provide farmers with a chance to assess how the milk pricing system is working before voting on the listing option.

¶10. Under the preferred option, the assets, liabilities and operations of the current co-operative would be shifted to the new company. The co-op and its farmer owners would retain a 65 percent stake, 15 percent would be distributed to farmers, and an additional 20 percent would be issued to external shareholders. Farmers would have the option of selling their shares on the stock market or keeping them.

¶11. The preferred option includes contractual, constitutional and legislative safeguards to help ensure New Zealand farmer majority ownership and New Zealand control. These include:

- The new company will contract with the co-op to pick up all milk produced by shareholders, maintain adequate processing facilities, and adhere to a milk pricing agreement.
- Only the co-op will be allowed to own more than 10 percent of shares.
- The co-op will not be able to own less than 50.1 percent without a 75 percent approval vote.
- The minimum co-op stake will be 35 percent.
- 50.1 per cent of shares must be held exclusively by New Zealanders, even if the co-op's stake drops to 35 percent.
- The co-op will have a board comprised of eight farmer directors and two independent directors.
- The co-op board will have the power to appoint the board of the new company, which will consist of six farmer and four independent directors.
- The two boards will share the same chairman and four farmer

directors.
- Fonterra headquarters will remain in New Zealand.
- Only New Zealand dairy farmers will be able to be shareholders of the co-op.

Rationale: "Behind the Borders"

¶12. Of all of the options considered, the preferred option reportedly best ensures that Fonterra will be able to raise capital at a competitive cost. It is estimated that NZ$2 to $3 billion (US$1.8 to $2.4 billion) could be raised through the share offering, which would enable Fonterra to pursue its growth strategy of expanding in the fastest growing markets around the world, including South America, China and other countries in Asia. In these markets, there is strong demand for fresh milk and Fonterra's strategy is to supply this demand by building profitable businesses in those countries by using locally-produced milk. In New Zealand, this strategy is commonly referred to as a "behind the borders" approach.

¶13. The preferred option also enables Fonterra to address redemption risk, which is significant. Farmers that supply Fonterra must purchase fair value shares proportional to the amount of milk supplied. These shares are fully redeemable if producers decide to cease supplying Fonterra. Because of the way the Fonterra cooperative was initially set up with a fair value shares system, Fonterra has virtually no permanent capital. The total value of all fair value shares represents the entire equity capital of Fonterra. By issuing non-redeemable, tradable shares that can be listed on the stock market, Fonterra would be able to minimize redemption risk. However, that solution opens them up to the risk that

the market could drive down the company's value.

Wall Street Reaction

¶14. Following the news of the planned restructure, Fitch Ratings announced it retained a negative outlook for the dairy giant and assigned its AA- (minus) credit rating. Standard & Poor's has reassessed Fonterra's rating and downgraded the outlook to a slightly negative, continuing the rating agencies' declining assessment of Fonterra begun a year ago based then on merger problems. Fonterra wants to maintain the highest positive ratings, but the rating agencies said the risks created by the co-operative's new proposals have slightly weakened its positive profile. In a worse case scenario in a share market arrangement, market analysts posit that farmer-suppliers could be "left in the cold," i.e., standing last in line of potential creditors to be paid. Currently, the annual milk payments are Fonterra's single biggest business cost. Under a revised capital restructure Fonterra would be able to raise capital to fund growth, rather than rely on debt, and would reduce redemption risk (more outside shareholders to hold risk). A Fitch analyst warned that while the capital restructuring has credit-enhancing features, it also requires a restructuring of the milk supply arrangements - potentially leading to a significant diminution in Fonterra's financial flexibility.

¶15. According to newspaper reports, a listed Fonterra would be worth between NZ$8.6 (US$6.9) and NZ$10 billion (US $8 billion), making it the largest company on the New Zealand stock market. (The next largest company is Telecom valued at NZ$7.7 billion (US$6.15).) Many in the industry expect the fair value share of Fonterra stocks owned by current shareholders to go down by approximately 35 percent because the cooperative's equity will be distributed - 15 percent to farmers and 20 percent to new investors.

Initial Reaction by Dairy Farmers

¶16. Despite the safeguards in the proposal and reassurances from Finance Minister Michael Cullen that Fonterra's plan would be in New Zealand's best interests, the initial reaction from farmers is mixed with most indicating that they need more information before they can make a decision. How the milk transfer price between the co-op and the new company will be determined is a key concern as this will determine how much of the operational subsidiary's after costs revenue will be passed on to producers in the form of higher milk prices and how much will be passed on to investors in the form of higher profits. The new board will be in the unenviable position of trying to balance the desires of farmers, who will want the highest possible milk price, and external investors, who will want the highest possible dividend. Under the current system, virtually all of Fonterra's revenue is passed on to dairy producers in the form of higher milk prices.

¶17. A team in Fonterra is working on a system to calculate the milk transfer price and aims to put a proposal before farmers in the next couple of months. Because there's no open market determined price for milk in New Zealand, coming up with a suitable mechanism that is transparent, competitive and fair will be tricky. According to Fonterra, the new system will build on the approach used by Duff & Phelps, the company that calculates the fair value of Fonterra shares. Farmers will need to be convinced that this system protects their interests before they vote to approve the listing plan.

¶18. Another concern among Fonterra shareholders is the issue of non-farmer dominance and encroaching foreign direct investment. While the scheme presented to stakeholders would have contractual and legislative safeguards to protect farmer control, along with New Zealand farmer majority ownership, many farmers are questioning whether these safeguards are adequate. While the proposed governance structure is intended to ensure farmer concerns are addressed, many see an inherent conflict of interest in the way boards are set up. Others have expressed concern that the co-op will still be exposed to significant redemption risk and capital management issues, which, in the minds of some could lead to a sell off of shares and increased external control, especially if there is a drop in the milk pay out price. (Note: If the milk pay out price drops and there is a loss of supply, the co-op would potentially be forced to sell shares to fund the farmers exiting the system. End note.) Another frequently heard complaint is that the Fonterra announcement was "big on spin" but "short on hard facts."

¶19. Comment: Fonterra's IPO, if successful, will have a major impact on the New Zealand economy but its impact on the global dairy market is not expected to be that significant. The success of the Fonterra IPO proposal depends largely on New Zealand milk producers being persuaded that Fonterra's "behind the borders" approach is the appropriate way forward and that their search for capital should extend to the riskier equity market. In the minds of many analysts, access to the capital markets through an IPO to expand Fonterra's overseas markets and maintaining exclusive domestic control of Fonterra are two mutually exclusive propositions. The interests of NZ dairy producers may ultimately be at odds with outside (international) shareholders. Throughout the early planning stages of the IPO proposal, New Zealand government officials from the Ministry of Agriculture and Forestry along with the Treasury had been in close consultations with Fonterra's Board in order to ensure national interests were adequately considered. New Zealand dairy farmers are yet to be convinced that the plan is in their interest.
McCormick